

Memorandum

DOL Issues Final Rule on ESG Investing and Proxy Voting

December 8, 2022

The U.S. Department of Labor (the “**DOL**”) recently issued a [final rule](#) (the “**Final Rule**”) that seeks to clarify the circumstances under which a fiduciary subject to ERISA may consider climate change and other environmental, social and governance (“**ESG**”) factors when making investment decisions (and exercising shareholder rights) on behalf of ERISA plans and “plan asset” vehicles.¹

Background

For nearly 40 years, the DOL has issued guidance that sought to provide a framework for ERISA fiduciaries considering investments for reasons other than investment performance (*i.e.*, “collateral factors”). ESG investing, impact investing, socially responsible investing and economically-targeted investing are examples of strategies that implicate collateral factors.

Unsurprisingly, the varied “[tone and tenor of \[DOL ESG\] guidance across Administrations](#)” over the years has led to confusion among fiduciaries as to how ERISA’s fiduciary duties with respect to making investment decisions squares, if at all, with the consideration of collateral factors. This resulted in the DOL under the Trump Administration issuing the [Financial Factors](#) rule, which clearly provided that an ERISA fiduciary could only consider “pecuniary factors” when making investment decisions and that consideration of collateral factors was permissible only under relatively rare circumstances. The Biden Administration alleged the *Financial Factors* rule created a “chilling effect” on ESG investing and proposed a new ESG rule on October 14, 2021.

The Final Rule

The DOL has now issued the Final Rule, which largely goes into effect on [January 30, 2023](#).²

At a high level, the Final Rule is not intended to encourage, much less mandate, a fiduciary’s consideration of ESG factors when making investment decisions (or exercising shareholder rights) related to investments held by a

¹ Many fund sponsors structure their funds to avoid being deemed to hold “plan assets,” such as by relying on the “venture capital operating company” and “real estate operating company” exceptions or by satisfying the “25% test.” In those instances, ERISA is *not* applicable to the management of those funds and the general partner (and investment manager) of such fund need *not* comply with the Final Rule. Please note that, while the Final Rule does not directly implicate the sponsor of a non-plan assets fund, the Final Rule may nonetheless affect its marketability to prospective ERISA plan limited partners. Moreover, governmental plans are *not* subject to ERISA; however, their governing laws *may* contain ERISA-like language and compliance therewith may be informed by DOL rules, such as the Final Rule.

² Certain provisions related to proxy voting have an effective date of Dec. 1, 2023.

plan. Instead, the Final Rule clarifies the ways in which an ERISA fiduciary may consider ESG factors, and exercise shareholder rights related to plan investments, in a manner consistent with ERISA's duties of prudence and loyalty. This memorandum highlights some of the salient points of the Final Rule.

- **Investment Risk/Return Factors.** The Final Rule reaffirms the DOL's longstanding position that a fiduciary should base its investment decisions on factors that the fiduciary reasonably determines are relevant to an investment's risk and return. Moreover, fiduciaries may not sacrifice investment returns or take on additional investment risk to further objectives that are unrelated to the provision of retirement or other financial benefits under the plan.
- **Tie-Breaker Test.** The Final Rule breathes new life into a fiduciary's ability to use an ESG characteristic of an investment, which does *not* affect risk/return, as the decisive factor in selecting one investment over another, provided both investment opportunities "equally serve the financial interests of the plan over the appropriate time horizon." This framework (known as the "tie-breaker" test) has long been available under DOL guidance. In 2020, however, the *Financial Factors* rule recast the tie-breaker test in such a way, and imposed such restrictions on its use, including a heightened documentation requirement, that some felt nullified the test itself. The Final Rule reinstates the tie-breaker test but disregards the additional documentation requirement, adding an additional tool for fiduciaries to consider ESG factors without violating ERISA's fiduciary duties.
- **QDIAs.** The Final Rule now provides that a plan fiduciary may select a "qualified default investment alternative" (QDIA), the default investment option on a 401(k) plan menu, under the same standard as any other investment option. This is a marked change from the *Financial Factors* rule, which provided that a fund could *not* be selected as a QDIA if it, or any of its component funds, had investment objectives, goals or principal investment strategies that included, considered or indicated the use of non-pecuniary factors.
- **Participant Preferences.** The Final Rule clarifies that fiduciaries do not automatically violate ERISA's duty of loyalty by taking plan participants' preferences into account when constructing a 401(k) plan lineup.
 - On the one hand, this aspect of the Final Rule may lead to greater incorporation of ESG funds in plan lineups. On the other, however, it remains to be seen how plan fiduciaries will actually ascertain the preferences of plan participants and whether the steps to gather that information may ultimately be an additional source of litigation risk. Lastly, it is imperative to note that fiduciaries remain duty-bound to prudently select investment options, such as by considering an investment option's track record, fees and expenses, etc., and this is an area that remains subject to relentless class action litigation.
- **ESG Factors as Investment Risk/Return Factors.** The Final Rule reiterates the DOL's historical position that fiduciaries can and should consider any and all factors that are relevant to the risk/return analysis.
 - In this respect, both the Final Rule and the DOL's prior authority over the past ten years, including the *Financial Factors* rule, all *expressly* acknowledge that ESG factors may, under certain circumstances,

in fact affect an investment's risk/return characteristics.³ This means that a fiduciary may consider the ESG factor alongside other relevant risk/return factors—without needing to satisfy the aforementioned tie-breaker test—if the fiduciary prudently determines that the factor is relevant to investment performance.

- **Shareholder Rights.** The Final Rule clarifies that the voting of proxies, and the exercise of other shareholder rights, with respect to ERISA plan assets is fiduciary conduct under ERISA. Moreover, proxies should be voted unless a responsible plan fiduciary determines voting proxies are not in the plan's best interest, such as where the costs to do so are exceptionally high.
 - This means that the fiduciary, when exercising shareholder rights on behalf of a plan, must (i) act solely in accordance with the economic interests of the plan, (ii) consider any costs involved, (iii) not subordinate the interests of the participants and beneficiaries in their retirement income or financial benefits to any other objective, and (iv) evaluate relevant facts that form the basis for the proxy vote or other exercise of shareholder rights.
- **Proxy Advisory Firms.** The Final Rule includes a general requirement that a fiduciary monitor proxy advisory firms, though it did not retain the more specific monitoring duties that were included in the *Financial Factors* rule. The DOL expects fiduciaries to assess the qualifications of the proxy advisors and the reasonableness of the fees for such services, as well as to be fully informed of potential conflicts of the proxy advisor and the steps such proxy advisor has taken to address them.

Next Steps

- ERISA fiduciaries may wish to revisit their agreements and related policies and procedures, including any proxy voting policies, to determine whether any amendments are appropriate.
- Fund sponsors with ESG strategies may wish to note that the Final Rule's permissibility of ESG strategies within QDIAs may allow for new opportunities to access ERISA capital.
- Investment managers that service governmental plans may wish to take note of efforts by various state legislatures related to ESG to ensure continuing compliance with the governmental plan's applicable laws.

³ See DOL Interpretive Bulletin 2015-01 (Oct. 26, 2015) ("Environmental, social, and governance issues may have a direct relationship to the economic value of the plan's investment."); DOL Field Assistance Bulletin 2018-01 (Apr. 23, 2018) ("[t]o the extent ESG factors, in fact, involve business risks or opportunities that are properly treated as economic considerations themselves in evaluating alternative investments, the weight given to those factors should also be appropriate to the relative level of risk and return involved compared to other relevant economic factors."); and 85 Fed. Reg. 72846, 72848 (Nov. 13, 2020) ("[t]he [Financial Factors] rule recognizes that there are instances where one or more environmental, social, or governance factors will present an economic business risk or opportunity that corporate officers, directors, and qualified investment professionals would appropriately treat as material economic considerations under generally accepted investment theories.").

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